The Fixed Income Digest - Supplement

Auction Market Securities

United States
04 February 2008

Merrill Lynch

Kevin J. Conery +1 212 449 0720
Strategist
[illegible]
[illegible]
Martin Mauro [illegible]
Fixed Income Strategist
[illegible]
[illegible]

Answering your questions about Auction Market Securities

We answer the questions that have come our way about Auction Market Securities.

Refer to important disclosures on page 4 to 5. Analyst Certification on page 3.

Answering your questions about auction market securities

Are Closed-End Fund preferred auction securities safe?

We consider CEF auction securities to be the conservative's conservative security. The fund and the fund manager must adhere to the provisions of the Investment Company Act of 1940.

- The fund is legally required to maintain the market value of the assets at a level equal to 200% of the face value of the auction market preferred. Typically, funds have asset coverage well above that threshold. Many funds maintain coverage levels at 300% or above. The preferred securities are the senior claim on the fund's assets.
- Under the regulations, funds are required to mark their assets to market every month. However, as a matter of good business practice, fund managers usually determine the market value either weekly or daily.
- If the fund is not able to meet the 200% asset coverage test, it must quickly remedy the situation. Historically, that has involved redeeming the security on the next auction date.
- Closed-end auction market preferreds have been around for 20 years. They have been through the S&L and banking crises of the late 1980s and early 1990s, the Asian contagion, and the 2002 accounting scandals.

Can I be sure of getting my money back when I want it?

Auction market securities do not provide the daily access to funds that money market funds do, but we think that the higher rates compensate for the slightly lesser degree of liquidity. Except in the rare case of a failed auction (see below), investors who choose to do so can receive their principal back at the next regularly scheduled auction. Depending upon the security, the auctions can reset at intervals of one week, one month, 49-days, or one quarter.

The rates on auction market securities seem too good to be true. What are we missing?

Rates on auction securities have been abnormally high in relation to other rates because of liquidity concerns, and in the case of some tax-exempt securities, concerns about the safety of the bond insurers. Liquidity concerns have been a common theme in the money markets since last summer.

We don't view the high spreads as a reason to worry. We are comfortable with the safety of auction securities from closed-end funds, municipals with an underlying credit rating of at least single-A, and Guaranteed Student Loan Issuers. We view the unusually high present level of rates as an opportunity rather than a cause for alarm.

How likely is a default?

A default on an auction market security would mean that the security no longer pays interest or dividends. Defaults are even rarer than failed auctions. We are not aware of a default on an auction market security since the early 1990s. Given the high credit quality of the vast majority of the auction market, and the historical record, we believe a credit default on an auction market security is a very low probability.

What is a failed auction?

A failed auction is one where there are more sellers than buyers, so that not all sellers can receive par value back. A failed auction is NOT a default.

In the event of a fail the investor can either: 1) liquidate the securities in the secondary market, but at a lower price than par, or 2) hold onto the security through subsequent auctions until an auction clears, the legal final maturity date, or when the issue is called. For the investor who holds on, the issuer will continue to pay interest on the security at a pre-determined higher maximum rate, as described in the issuer's prospectus. The rate is usually based on a markup above a designated market index. That rate is usually higher than the rate that would have cleared at the auction, and provides an incentive for the issuer to call the security.

How often do closed-end fund auctions fail?

Hardly ever. There was one failed auction on January 22, 2008. But that was an isolated event that involved only a small number of shares, and the next auction from that same closed-end fund was successful. Prior to the recent episode, the last failure that involved closed end fund securities held by individual investors was in 1990.

The auction failures in 1990 stemmed from the descent to insolvency of Drexel, Burnham, Lambert, who was the sole broker-dealer involved in the auctions. The fails lasted for several months until a new broker-dealer began supporting the auctions. Investors who held on did not lose money, as they received par value back when the auctions resumed with the new broker dealer.

What about the auction market securities backed by monoline insurers?

Although we don't expect the AAA-rated insurers to fail, we believe it is prudent for investors to evaluate insured securities on the basis of the underlying rating without the insurance. Most of the municipal bonds that are part of the auction market have a rating of A- or higher, and the monoline insurers follow a "zero loss" policy in insuring bonds. The historical default rate on investment grade municipal bonds is less than 0.1%, according to a Moody's report.

How do the relatively high auction market rate spreads affect the common shares of the closed-end funds?

Auction market rates have been higher than normal in relation to other rates, although the absolute level of rates has declined recently as the Fed has been cutting rates. To the extent that these rates remain high, they raise the costs of leverage for closed-end funds, and therefore hurt the earnings of the funds.

Analyst Certification

We, Martin Mauro and Kevin J. Conery, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Important Disclosures

Due to the nature of strategic analysis, the issuers or securities recommended or discussed in this report are not continuously followed. Accordingly, investors must regard this report as providing stand-alone analysis and should not expect continuing analysis or additional reports relating to such issuers and/or securities.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

Other Important Disclosures

Merrill Lynch fixed income analysts regularly interact with Merrill Lynch sales and trading desk personnel in connection with their research, including to ascertain pricing and liquidity in the fixed income markets.

Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.: Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow; Merrill Lynch (Turkey): Merrill Lynch Yatirim Bankasi A.S.; Merrill Lynch (Dubai): Merrill Lynch International Bank Ltd, Dubai Branch; MLPF&S (Zürich rep. office): MLPF&S Incorporated Zürich representative office.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; is issued and distributed in India by DSP Merrill Lynch Limited; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) distributes this report in Germany. Merrill Lynch (Frankfurt) is regulated by BaFin.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

The bonds of the company are traded over-the-counter. Retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale. MLPF&S usually makes a market in the bonds of this company.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at http://www.ml.com/media/43347.pdf.

Fixed income research reports relating to securities covered by our Credit Rating Scale are produced on a regular basis as necessary to keep the investment recommendations current. Analysis on fixed income securities and financial instruments not covered by the Credit Rating Scale is provided on a stand alone basis and investors should not expect additional reports relating to such securities or financial instruments.